Isotechnika inc.

2003 Annual Report

Dr. Robert Foster
Chairman & CEO
Isotechnika Inc.

ISOTECHNIKA INC. IS AN INTERNATIONAL BIOPHARMACEUTICAL COMPANY DEDICATED TO THE DISCOVERY, DEVELOPMENT AND COMMERCIALIZATION OF NOVEL IMMUNOSUPPRESSIVE THERAPEUTICS FOR USE IN THE PREVENTION OF ORGAN REJECTION IN TRANSPLANTATION AND IN THE TREATMENT OF AUTOIMMUNE DISEASES.

SINCE INCEPTION TEN YEARS AGO, OUR COMPANY'S GROWTH AND DEVELOPMENT, WITH ITS ENTREPRENEURIAL MANAGEMENT AND WORLD-CLASS SCIENTIFIC TEAM, HAS BROUGHT US EVEN CLOSER TO OUR ULTIMATE GOAL - TO BECOME A LEADER IN THE FIELD OF IMMUNOSUPPRESSION.

OUR DEDICATION AND PERSEVERANCE HAS ALREADY RESULTED IN THE DISCOVERY OF THREE COMPOUNDS WITH SIGNIFICANT POTENTIAL. OUR SPHERE IS EXPANDING - OUR VISION IS BECOMING A REALITY.

LETTER TO THE SHAREHOLDERS

Isotechnika continued to achieve success in its tenth year of operation. Our lead drug candidate, ISA247 successfully completed a Phase II trial in both renal transplantation and psoriasis. Both trials achieved all of the primary and secondary endpoints and showed that ISA247 was well tolerated and efficacious.

Over the last year, we have continued to optimize the manufacturing process of ISA247. When we initiated this process, ISA247 was approximately an equivalent mixture of two geometric isomers (called, trans and cis), where just one of the isomers (trans) carried most of the desired immunosuppressive activity. We have now changed our manufacturing so that the drug is comprised mainly of the more active trans isomer. This change in the manufacturing process has received approval from the Food and Drug Administration (FDA) in the United States.

Optimization of the drug manufacturing process, predominantly resulting in production of the trans isomer, has advantages from an economic, regulatory and clinical perspective. Manufacturing cost of ISA247 will be significantly reduced, while adhering to the FDA recommendations for moving toward single isomer drug entities in the course of clinical development. By proceeding with development of the more active trans isomer, we are confident that correlations between drug concentrations in blood and desired clinical effect will be enhanced. As therapeutic drug monitoring is an important aspect of immunosuppressive therapy, this enhanced correlation should allow the use of trans-ISA247 to be more clinically robust. We also anticipate that this will facilitate the progression of trans-ISA247 through the clinical trial process, at reduced cost.

With the manufacturing process now finalized, large scale batches of ISA247 can now be made in a cost-effective and consistent manner. Isotechnika is required to conduct dose-range finding studies with trans-ISA247 prior to commencing future clinical trials, as it is anticipated that lower doses of the more active trans-ISA247 will be needed compared with the previous cis-trans mixture. By the time this letter is received by shareholders, one such study should be close to completion. Preliminary results of the study are expected by the end of the second quarter. As mandated by the FDA, a QTc study will be undertaken prior to moving into late stage clinical trials with ISA247. The anticipated start date for the QTc study is mid-2004.

Isotechnika continues to expand its immunosuppressive drug pipeline following the relatively recent announcement of the discovery of two additional drug candidates. Use of these two new candidates will complement the use of ISA247 in both transplantation and in treatment of autoimmune diseases. The first candidate, TAFA-93, was announced on May 21, 2003. TAFA-93 is a novel mTOR inhibitor; a class of drugs currently used in the prevention of organ rejection in transplantation and as a coated stent therapy in the treatment of coronary artery disease. Early pre-clinical studies of TAFA-93 have demonstrated promising pharmacokinetic results which are distinct from other drugs in its class such as Rapamycin. An Investigational New Drug (IND) application for TAFA-93 is scheduled to be filed in 2004 with a Phase I human trial commencing shortly thereafter.

TKB662, the second immunosuppressive drug candidate to be discovered in 2003, is designed to overcome two significant transplantation hurdles. These hurdles are namely chronic rejection and unwanted side effects resulting from steroid use. To date, pre-clinical studies of TKB662 have demonstrated decreased T cell and B cell activation and proliferation through multiple mechanisms of action. These findings suggest that the need for steroid use may be obviated. We will continue pre-clinical testing of TKB662 throughout the year.

Positive and interesting developments also occurred in our diagnostics division. In addition to our diagnostic test for the detection of the ulcer causing H.pyloria bacteria, we successfully developed a second diagnostic test, called Diatest®. This test determines the extent of insulin resistance in patients. Insulin resistance is the primary cause of type 2 diabetes, and clinical test results using our Diatest® kit were published in a recent peer-reviewed issue of Diabetes Care. The study provides the necessary validation to start commercial development of the Diatest®. It is expected that this test will be made available to primary care physicians in Canada later this year. The Company currently holds two United States patents for the Diatest®.

Sales of our original diagnostic product Helikit® continue to grow. We have recently increased our international distribution of Helikit® through the signing of new marketing agreements with companies in the Middle and Far East. We are confident that our diagnostic division will continue to add value to the Company by enhancing our cash flow.

International recognition continues to be garnered for our company and its products. Throughout the year, our senior management team has presented at key scientific and investor conferences around the globe. The Company was also acknowledged for its continued growth and was named to numerous national and international ranking programs: Profit 100, Deloitte and Touche's Fast 50 Program, and Alberta Venture's 30 Fastest Growing Companies, to name a few.

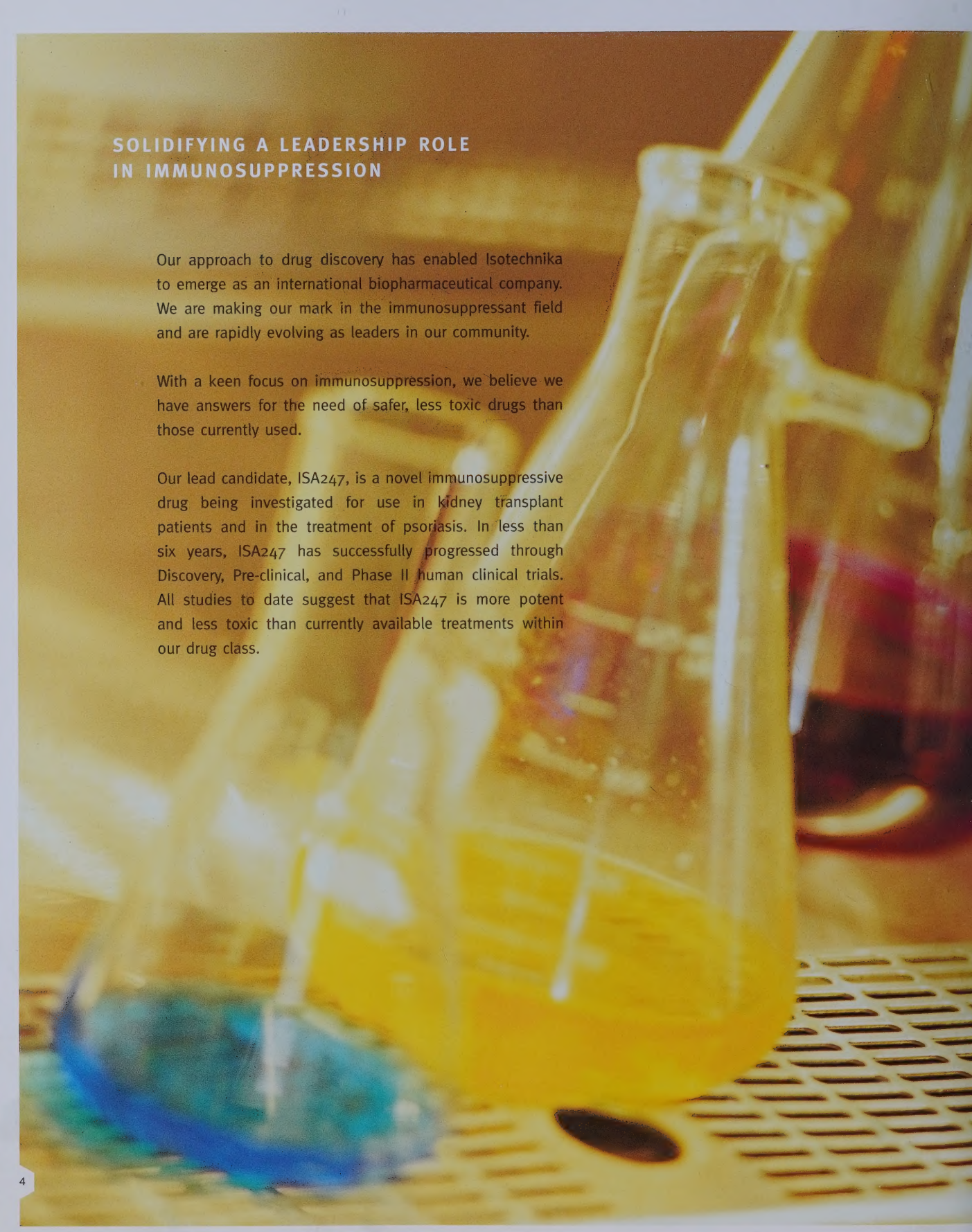
The Company's global intellectual property protection for ISA247 continues to be strengthened. In addition to receiving two United States patents for ISA247 in 2003, a notice of allowance from the United States Patent Office for an additional patent was granted this past February. Isotechnika has patent protection for ISA247 in Australia, Canada, New Zealand, and the United States with additional patents pending in other countries. It is our strategy to continue to pursue additional patentable claims for ISA247 where appropriate.

Our cash position increased to $81.5 M as of December 31, 2003 from $64.2 M over the same period in fiscal 2002. This increase was attributed to a milestone payment in the amount of $21.9 M from our collaborative partner Roche following the positive clinical results achieved in the Phase II ISA247 psoriasis trial. The payment comprised of $8,355,000 CDN in cash and $13,545,000 CDN in further equity investments. On July 17, 2003, the Company completed a $15,000,000 US private placement with Banc of America serving as lead placement agent for equity financing, with Freidman Billings Ramsey & Co., Inc. acting as a co-manager. The financing was solely subscribed by U.S. based institutional investors. As a result we have received increased recognition by international institutional investors. Our goal is to continue to raise awareness of our company and its products in the upcoming year.

With the commitment and dedication of our staff, we continue to forge ahead. Our focus in becoming one of the leaders in development of novel immunosuppressive therapies remains clear as we move our compounds through development. We appreciate the ongoing support of our shareholders, partners and collaborators. By expanding our sphere we are building our future.

ROBERT FOSTER, Ph.D.
CHAIRMAN & CHIEF EXECUTIVE OFFICER

RANDALL W. YATSCOFF, Ph.D., FCACB
PRESIDENT & CHIEF OPERATING OFFICER



SOLIDIFYING A LEADERSHIP ROLE IN IMMUNOSUPPRESSION

Our approach to drug discovery has enabled Isotechnika to emerge as an international biopharmaceutical company. We are making our mark in the immunosuppressant field and are rapidly evolving as leaders in our community.

With a keen focus on immunosuppression, we believe we have answers for the need of safer, less toxic drugs than those currently used.

Our lead candidate, ISA247, is a novel immunosuppressive drug being investigated for use in kidney transplant patients and in the treatment of psoriasis. In less than six years, ISA247 has successfully progressed through Discovery, Pre-clinical, and Phase II human clinical trials. All studies to date suggest that ISA247 is more potent and less toxic than currently available treatments within our drug class.

RENAL STUDY SUMMARY

The Phase IIa renal transplant trial was designed to evaluate ISA247 in stable kidney transplant patients.

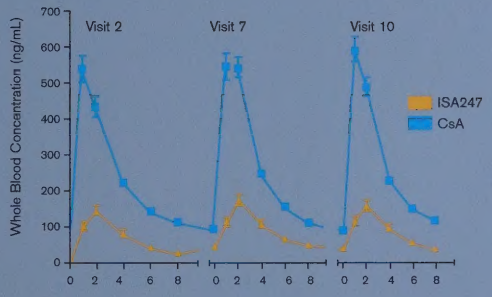
The kidney transplant study was an open label, randomized trial conducted at 20 centers in Canada and the United States. The study was designed for stable kidney patients who were at least six months post-transplant. The study was randomized with one patient receiving a dose of ISA247 and one patient receiving a dose of cyclosporine. A total of 132 patients participated in the twelve week study with 67 patients receiving cyclosporine and 65 patients receiving ISA247. During the study, and for one week after the study, ISA247 patients were closely monitored prior to being returned to their previous cyclosporine dosing regimen.

The primary endpoint of the trial was to demonstrate that stable kidney transplant patients on ISA247 experienced no change in kidney function when compared to patients on cyclosporine (Neoral®). The secondary endpoint of the study was to measure the pharmacodynamics and pharmacokinetics of ISA247 in kidney transplant patients. All of these endpoints were met.

Patients receiving ISA247 showed no change in kidney function when compared to those receiving cyclosporine thereby providing further confirmation of drug safety. This trial shows that kidney transplant patients can switch to ISA247 in a safe and effective manner. Additionally, no rejection episodes occurred with ISA247 use.

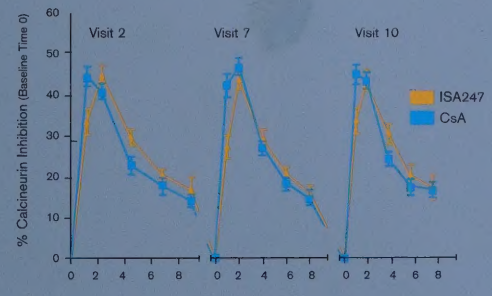
Drug concentrations of cyclosporine (Neoral®) in blood were three times higher than for ISA247. However, activity of both drugs measured as calcineurin inhibition was identical. This indicates that ISA247 is at least three times more potent than cyclosporine (Neoral®) which is consistent with all pre-clinical and Phase I trial results.

Conclusion: The trial showed positive results and demonstrated that ISA247 was well tolerated and efficacious. All primary and secondary endpoints of the study were achieved.



Pharmacokinetic
Whole Blood Concentration (mean ± SEM)

In the Renal Switch trial, ISA247 was compared to cyclosporine A. This graph demonstrates the difference in exposure of the two drugs with almost 3-fold higher cyclosporine blood concentrations compared with ISA247.



Pharmacodynamic
Percent Calcineurin Inhibition (mean ± SEM)

The relationship between drug concentration and its effect on the body can be measured by calcineurin inhibition. Although the blood concentration of ISA247 was three fold less than cyclosporine, the level of inhibition was the same. This confirms the increased potency of ISA247.

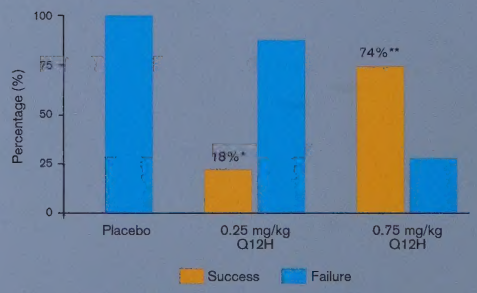
PSORIASIS STUDY SUMMARY

The Phase II psoriasis trial was designed to evaluate ISA247 in patients with severe psoriasis.

The trial was a double-blind placebo controlled study performed at 12 centers in Canada with 201 patients participating in total. The twelve week study was randomized such that for every 2 patients receiving the high dose of ISA247 (0.75 mg/kg) twice a day, there were 2 patients receiving the low dose of ISA247 (0.25 mg/kg) twice a day and only 1 patient on placebo. During the study, and for an additional 6 week period, patients were monitored. The primary objectives of the trial were to evaluate the efficacy and safety of ISA247 in the treatment of psoriasis.

The primary efficacy endpoint for the study was achievement of a 2 point reduction in the Static Global Assessment scores from baseline to the end of the treatment period. At the high dose, the data showed that 54% of the patients achieved this parameter as compared to 17% at the low dose and 0% with placebo. One of the secondary efficacy endpoints for the trial was achievement of a 75% reduction in Psoriasis Area and Severity Index (PASI) patient scores from baseline to the end of the treatment period. At the high dose, the data showed that 74% of patients achieved this parameter as compared to 18% at the low dose and 0% with placebo. These efficacy results were achieved without any significant adverse effect on blood pressure or lipid levels. The mean serum creatinine levels remained within the acceptable reference range indicating normal kidney function was maintained for all dosing groups.

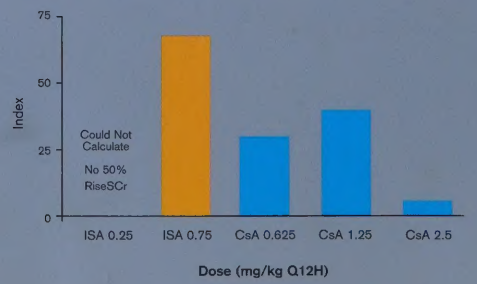
Conclusion: The trial demonstrated that ISA247 was well tolerated and efficacious. The results showed that ISA247 met or exceeded all of the primary and secondary efficacy and safety endpoints of the study.



* Different than Placebo, p < 0.0001 Cochran-Mantel-Haenszel
** Different than 0.25 mg/kg Q12H, p < 0.0001 Cochran-Mantel-Haenszel

PASI Scores

In the psoriasis trial, one of the markers of clinical success was defined as a 75% reduction in the Psoriasis Area and Severity Index (PASI). The study demonstrated that 18% of patients receiving only 0.25 mg/kg twice daily achieved this success rate while a higher dose of 0.75 mg/kg twice daily increased this to a 74% success rate.



Efficacy 70/Toxicity 50 Index

Since a useful drug must balance effectiveness (efficacy) with toxicity, this slide illustrates a defined efficacy/toxicity index for the drug. In this case the same 75% reduction in PASI score was taken for efficacy, while toxicity was defined as a 50% increase in serum creatinine, a blood marker for renal function. In comparison to historical cyclosporine A controls, ISA247 demonstrates a better efficacy/toxicity index.

RENAL

I have been doing trials with cyclosporine compounds since the early 1980's. I am very impressed with the new compound by Isotechnika. In stable renal transplant patients their formulation was well tolerated with no adverse effects, and produced stable serum creatinine and drug levels. It will be a player in the marketplace.

Duane G. Wombolt, M.D., F.A.C.P.
President, Clinical Research Associates of Tidewater
Norfolk, VA

22 Sites
132 Patients
Trial Completed - January 2003

Richard Mandlis - Renal Transplant Patient

As the first transplant patient to receive ISA247, I knew there was no guarantee but it was an opportunity to help others benefit from my experience. ISA247 increased my quality of life; I welcome the opportunity to go back on ISA247 as soon as it is made available. Please talk to your families about organ donation, it's the greatest gift you can give.

PSORIASIS

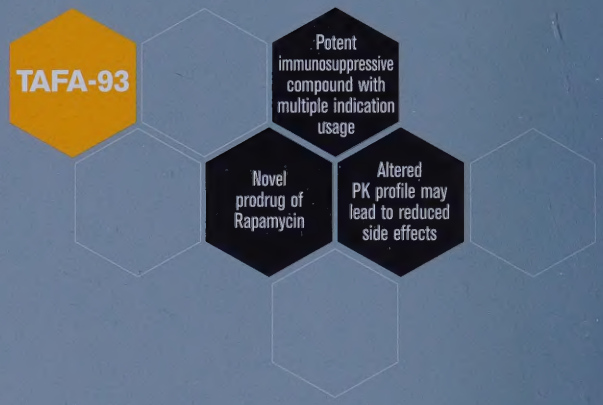
The efficacy of ISA247 for the treatment of psoriasis is impressive. Many of my patients cleared or improved by more than 90% during the trial. The drug works extremely well and should definitely move into Phase III.

Robert Bissonnette, M.D., M. Sc., F.R.C.P.C.
Dermatologist, Innovaderm Research Inc.
Montreal, PQ

12 Sites
201 Patients
Trial Completed - November 2002

Tina MacDougall - Psoriasis Patient

If there was one disappointment about my whole experience, it was that the trial had to end. ISA247 gave me the personal freedom and confidence to participate in everyday activities that were once a challenge. I've tried other products on the market and never received such impressive results.



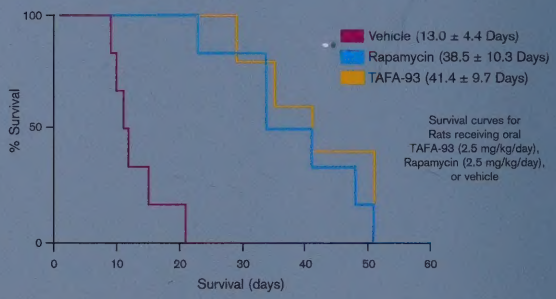
PRE-CLINICAL SUMMARY

Our second drug candidate TAFA-93 was announced on May 21, 2003. TAFA-93 is a novel prodrug of the mTOR inhibitor Rapamycin. TAFA-93 has been designed to attenuate the unfavorable pharmacokinetics and side effects of Rapamycin which presently limit its broader use. mTOR inhibitors are currently used in the prevention of organ rejection in transplantation, in the treatment of autoimmune and oncological diseases, and as a component of coated stents for the treatment of coronary artery disease.

In pre-clinical studies, TAFA-93 has demonstrated favorable results. Figure 1 illustrates that TAFA-93 is a potent immunosuppressant, showing equivalent efficacy to Rapamycin in a heart transplant model, while maintaining 1/3 lower exposure to Rapamycin (Figure 2). The promising altered PK profile (Figure 2) may also reduce mTOR class side effects which include hyperlipidemia, thrombocytopenia, delayed wound healing and gastrointestinal effects. For example, in a 12-day head-to-head study in rats, cholesterol levels were shown to be significantly lower when animals were dosed with TAFA-93 as compared to Rapamycin (Figure 3).

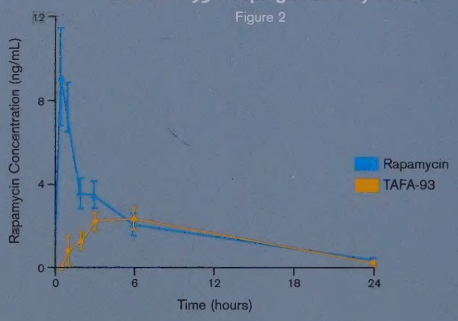
Efficacy of TAFA-93 in a Rat Heart Transplant Model

Figure 1



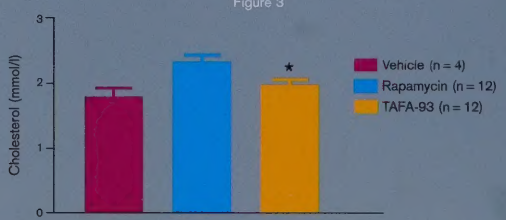
Acute Whole Blood PK Profiles for Rapamycin and TAFA-93 in Sprague Dawley Rats

Figure 2



Cholesterol Levels Following 12-Day Chronic Dosing of TAFA-93 and Rapamycin (2.5 mg/kg/day) in Sprague-Dawley Rats

Figure 3



* Significantly Lower than Rapamycin P< 0.01

ISA247

Optimizing the formulation, the manufacturing process, and the dosing has been, and continues to be, a high priority. We are also completing a study required by the Food and Drug Administration focused on the effects of ISA247 on cardiac function. Upon completion of all necessary studies, ISA247 will continue to advance through the later stage clinical development process.

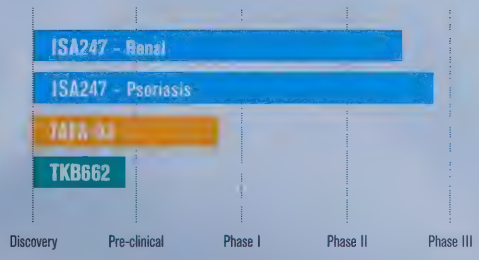
TAFA-93

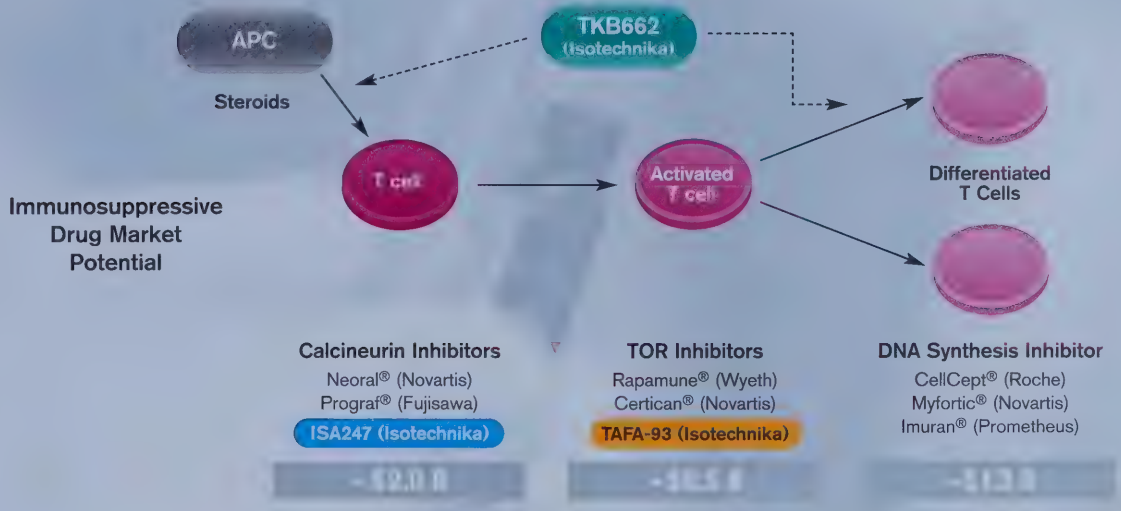
All required pre-clinical studies have been completed. We anticipate filing the IND (Investigational New Drug) application in 2004. Site recruitment and protocol development for the Phase I human clinical trial is underway.

TKB662

Pre-clinical studies will continue in 2004, addressing the two major challenges in the field of transplantation, namely chronic rejection and side effects resulting from steroid use. We anticipate filing an IND (Investigational New Drug) application in early 2005.

Clinical Development Process





EXPANDING OUR SPHERE THROUGH BUSINESS DEVELOPMENT

During the past year, Isotechnika has set up a team led by Executive Vice President, Joseph Koziak, to explore business development opportunities from both an in-licensing and out-licensing perspective. Encouraged by this team's ability to put together large deals, we feel that additional growth can come from future business development interests.

Currently, the team is looking at out-licensing options for the Company's Diatest® as well as its most recent additions to the immunosuppressive drug pipeline, TAFA-93 and TKB662. Additional opportunities exist through the acquisition of novel molecules. This team has, and will, continue to investigate potentially and commercially viable products in the immunomodulating field.

THREE MOLECULES

TREATING MULTIPLE INDICATIONS

SAVING & PROLONGING LIVES

BUILDING OUR FUTURE

CORPORATE INFORMATION

BOARD OF DIRECTORS

Robert Foster
Chairman & Chief Executive Officer
Director

William Hoskins
Director [1,2,3]

Joseph Koziak
Executive Vice President
Director

Lawrence Meyer
Director [2,3]

Donald Schurman
Director [1,2,3]

Douglas Walker
Director [1,2,3]

Randall Yatscoff
President and Chief Operating Officer
Director

SCIENTIFIC ADVISORY BOARD

Philip Belitsky M.D., FRCS(C)

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Gilles J. Lauzon Ph.D., M.D., FRCP(C)

Walter Maksymowych M.D., FRCP(C)

1 Audit Committee
2 Compensation Committee
3 Corporate Governance Committee

CORPORATE OFFICERS

Robert Foster Ph.D.
Chairman and Chief Executive Officer
Director

Randall Yatscoff Ph.D., FCACB
President & Chief Operating Officer
Director

Joseph Koziak LL.B.
Executive Vice President
Director

Launa Aspeslet Ph.D., RAC
Vice President, Medical and Regulatory Affairs

David Kinniburgh Ph.D.
Vice President, Lab Operations

Dennis Bourgeault C.A.
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MEDICAL DIRECTOR

Norman Kneteman M.D., FRCS

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EXCHANGE LISTING

Toronto Stock Exchange
Trading Symbol: ISA

SHARE REGISTRAR AND TRANSFER AGENT

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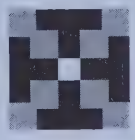
Suite 530, 8th Avenue SW
Calgary, Alberta
Canada T2P 3S8

ANNUAL GENERAL MEETING

Thursday May 13, 2004
10:00 am
Le Royal Meridien King Edward Hotel
Toronto, Ontario, Canada



Isotechnik

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MANAGEMENT'S

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Gilles J. Lauzon Ph.D., M.D., FRCP(C)

Walter Maksymowych M.D., FRCP(C)

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Chief Financial Officer

MEDICAL DIRECTOR

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EXCHANGE LISTING

Toronto Stock Exchange
Trading Symbol: ISA

SHARE REGISTRAR AND TRANSFER AGENT

Computershare Trust Company of Canada
Suite 530, 8th Avenue SW
Calgary, Alberta
Canada T2P 3S8

ANNUAL GENERAL MEETING

Thursday May 13, 2004
10:00 am
Le Royal Meridien King Edward Hotel
Toronto, Ontario, Canada

2003 Annual Report

MANAGEMENT'S DISCUSSION AND ANALYSIS & FINANCIALS

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Management's Discussion & Analysis

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the audited consolidated financial statements and accompanying notes, which are prepared in accordance with generally accepted accounting principles in Canada (Canadian GAAP). This Management's Discussion and Analysis as of March 25, 2004 provides information on the activities of Isotechnika Inc. ("Isotechnika" or the "Company") on a consolidated basis and all amounts are expressed in Canadian dollars unless otherwise noted.

OVERVIEW

Isotechnika is an international biopharmaceutical company headquartered in Edmonton, Alberta. It also has operations in Arizona, USA and Barbados. The Company is focused on developing immunosuppressive drugs to prevent organ rejection and to treat autoimmune diseases. Isotechnika's lead product, ISA247 is a novel, immunosuppressive drug currently under development for renal transplantation and psoriasis.

Two new drug candidates were also announced during the past year: TAFA-93 and TKB662. Both of these drugs inhibit the immune system at different sites as compared to ISA247. As the prevention of organ rejection subsequent to transplantation requires multiple drug therapy, these drugs are designed to complement the use of ISA247 for this indication. Overall, the Company strives to create novel immunosuppressive therapies with significantly improved pharmacologic properties (e.g. reduced toxicities).

The Company also develops, licenses and sells diagnostic products and services, such as the Helikit® breath kit and the Isomax series of Point-of-Care instruments for use with these kits. The Company has also developed a second diagnostic test, called Diatest®.

ISA247 DEVELOPMENT

On April 9, 2002 the Company entered into a strategic collaboration with F. Hoffmann-La Roche Ltd. and Hoffmann-La Roche Inc. (collectively "Roche") for the global co-development and commercialization of ISA247. Under the terms of the Collaboration Agreement, Roche was granted the worldwide rights to manufacture market and sell ISA247 product for all indications.

In 2002, the total financial contribution from Roche amounted to $45.67 million comprised of development, milestone and option fee payments of $17.28 million, $10.09 million in ISA247 development cost recoveries and $18.3 million in equity investment.

During 2003, the Company announced the successful completion of two clinical trials, as all the primary and secondary endpoints were met. These trials were conducted in North America, specifically testing ISA247 in renal transplantation and in psoriasis. Pursuant to the terms of the strategic collaboration, the Company achieved a scientific milestone for completion of the Phase II psoriasis trial. Accordingly, the Company received a milestone payment of $21.9 million on May 15, 2003. This payment was comprised of $8.36 million, recorded as revenue from collaboration partner (Roche), and $13.54 million as an equity investment.

Isotechnika wants to aggressively pursue the advancement of ISA247 for psoriasis and other such autoimmune diseases. The Company has initiated negotiations, which are currently ongoing, with Roche to reacquire the rights from Roche for all of the autoimmune indications for ISA247. These negotiations could result in changes to the existing Collaboration Agreement with Roche and could impact the extent of development costs incurred by Isotechnika in the future.

Subsequent to the year-end, the Company announced that the ISA247 formulation and manufacturing process was finalized. This announcement was made on February 19, 2004. When manufacturing was first undertaken, ISA247 was approximately an equivalent mixture of two geometric isomers (called "cis" and "trans"). Isotechnika has now changed the manufacturing to a point where the drug is comprised predominantly of the more active trans isomer. The trans-ISA247 will reduce the manufacturing cost while adhering to the Food and Drug Administration of the United States of America (FDA) recommendations that single isomer drug entities should be developed where possible. As this changed trans-to-cis ratio likely results in changes in overall drug efficacy, additional dosing trials are necessary. The FDA has therefore agreed to a single ascending dose range finding study for the trans-ISA247 version in humans. The study commenced on March 9, 2004 and includes 46 subjects. The Company also needs to perform a QTc human clinical trial, a multiple ascending dose range finding study and a food effect study. It is the goal of the Company to make an application to regulatory authorities for commencement of a Canadian Phase III psoriasis study by the end of 2004 and for commencement of a Phase IIB renal transplant study in both the U.S. and Canada in the first half of 2005.

Several factors could affect the timelines for advancing ISA247 into a Canadian Phase III psoriasis trial. One risk factor is the length of time to manufacture adequate supply of trans-ISA247. Additional risks include the timing of patient recruitment for the trials and the timing of receiving regulatory approval to perform each of the planned trials beyond the single ascending dose study.

TAFA-93 DEVELOPMENT

TAFA-93 is a novel small molecule mTOR inhibitor, a class of drugs currently used in the prevention of organ rejection in transplantation. TAFA-93 also has the potential to be used in coated stent therapy in the treatment of coronary artery disease, for treatment of autoimmune diseases and for oncology. TAFA-93 has been designed to attenuate the unfavorable side effects of rapamycin which presently limits its broader use. Pre-clinical trials with this drug are presently underway. It is the goal of the Company to move this compound into human clinical trials within the next year. As such, the Company expects to continue to incur costs in 2004 related to performing the required pre-clinical studies.

TKB662 DEVELOPMENT

This third drug candidate was announced on December 2, 2003. TKB662 is designed to address the two major challenges in the field of transplantation, namely chronic rejection and side effects resulting from steroid use. Early pre-clinical studies have demonstrated inhibition of T cell and B cell activation and proliferation through multiple mechanisms of action of lymphocyte phosphorylation activity. The multiple sites of action have the potential to reduce steroid-associated side effects to which the majority of transplant patients are now subjected. The Company plans to advance this drug through the pre-clinical stage in 2004 and as such will incur costs for technical development and required pre-clinical studies.

DIATEST DEVELOPMENT

The Company has developed a diagnostic breath kit called the Diatest®. This test is designed to be used to determine insulin resistance in patients. Insulin resistance is the precursor of type 2 diabetes. Clinical trial results using the Diatest® kits were published in a recent issue of the peer reviewed journal called "Diabetes Care." The study provides the Company with the necessary validation to start commercial development of the Diatest®. The Company expects that the test will be commercially available to primary care physicians in Canada later this year. The Company has already received regulatory approval and has the required license to sell the Diatest® in Canada. The Company also expects to commence the necessary clinical trials over the next year to obtain regulatory approval in the United States. The Company currently holds two United States patents for the Diatest®.

In summary, the Company expects to incur substantial research and development expenditures in 2004. This trend is expected to continue into future years as ISA247 development continues and as TAFA-93 and TKB662 move into clinical trials.

A summary of the development stage for each of the drug candidates is as follows:

Product Candidate	**Indications**	**Development Status**
ISA247	Psoriasis	Completed Phase II trial
ISA247	Renal Transplantation	Completed Phase IIA trial
TAFA-93	Transplantation	Pre-clinical studies
TKB662	Transplantation	Pre-clinical studies

Selected Annual Financial Information for the last three years ended December 31 (in thousands of dollars, except for loss per share)

	2003	2002	2001
Revenues	$9,935	$18,761	$7,011
Net loss	(18,993)	(576)	(11,788)
Loss per share	(0.27)	(0.01)	(0.23)
Total assets	96,524	79,784	59,003
Long term debt and obligations under capital leases	551	409	204

Notes:
(1) The Company had no discontinued operations or extraordinary items during the above noted years
(2) No dividends have been declared during the above noted years

RESULTS OF OPERATIONS

For the year ended December 31, 2003 the Company reported a consolidated net loss of $18.99 million or $0.27 per common share, as compared to a consolidated net loss of $576,000 or $0.01 per common share for 2002 and $11.79 million or $0.23 per common share for 2001. The increase in the consolidated loss for 2003 compared to 2002 was primarily attributable to a decrease in revenue from collaboration partner to $8.36 million in 2003 compared to $17.28 million in 2002 and a foreign exchange loss incurred in 2003 of $5.77 million compared to a foreign exchange gain of $250,000 recorded in 2002. Both items are discussed in more detail below in the relevant sections. The most significant factor that affected the financial results of the Company and the comparability of these financial results over the past three years was the signing of the Collaboration Agreement with Roche in fiscal 2002, which has been discussed in the ISA247 development section above.

Revenues

Revenue decreased by $8.82 million to $9.94 million for the year ended December 31, 2003 as compared to $18.76 million for 2002.

This decrease in revenue was primarily attributable to the following:

(1) In 2003, the Company earned an $8.36 million milestone payment from Roche that was recorded as Revenue from collaboration partner in the second quarter ended June 30, 2003. Revenue for 2002 included Revenue from collaboration partner of $14.10 million, $7.82 million which the Company received upon the signing of the Collaboration Agreement with Roche on April 9, 2002 and $6.28 million received in the third quarter of 2002 upon successful completion of a non-human toxicity study.

(2) In 2002, the Company received an option fee of $3.18 million from Roche which it recorded as review and option fee revenue. There was no comparable revenue received in 2003, as no option agreements were entered into.

Contract analysis and product sales revenues increased to $1.58 million for 2003 compared to $1.48 million for 2002, an increase of $100,000 or 7%. The Company increased sales of its diagnostic products (Helikit® breath kits and Isomax instruments) both in Canada and Southeast Asia. Contract analysis and product sales revenues are forecast to increase by approximately 25% for 2004 due to higher forecast sales in China. Isotechnika expects its principal source of revenue for 2004 to be contract analysis and product sales.

Expenses

Expenses increased by $3.29 million or 15% to $24.48 million for the year ended December 31, 2003 compared to $21.19 million for the year ended December 31, 2002.

Research and Development

The Company has dedicated a significant amount of its cash resources to research and development ("R&D") activities. The major components of R&D expenditures for the last two years were as follows:

R&D Expenditures (in thousands of dollars)	2003	2002	Increase (Decrease)
	$	$	$
Clinical trial costs	3,332	9,643	(6,311)
Pre-clinical costs	1,790	4,371	(2,581)
Technical, analytical and drug supply	3,417	5,590	(2,173)
Infrastructure costs	1,776	668	1,108
Other R&D costs	1,351	1,009	342
Total R&D expended by Isotechnika	11,666	21,281	(9,615)
Recovery from Roche for 70% of ISA247 costs incurred by Isotechnika	(4,155)	(11,842)	(7,687)
Subtotal	7,511	9,439	(1,928)
Charge to Isotechnika for 30% of ISA247 costs incurred by Roche	4,320	1,748	2,572
Net research and development costs	11,831	11,187	644

Clinical trial costs

The Phase II psoriasis trial was completed in November 2002, with final results released in the first half of 2003. The data showed that ISA247 met or exceeded all of the primary and secondary efficacy and safety endpoints for the study. The primary endpoint of the trial was a 2-point reduction in SGA score in patients suffering from moderate to severe psoriasis.

The Phase IIA renal transplant trial was completed in January 2003. The trial showed positive results and demonstrated that ISA247 was well tolerated and efficacious. All primary and secondary endpoints of the study were achieved. The primary endpoint of the trial was to demonstrate that stable kidney transplant patients on ISA247 experienced no change in kidney function when compared to patients in the cyclosporine (Neoral® formulation) arm of the study, with no changes in acute rejection episodes.

As these clinical trials were completed with final results released in the first half of 2003, clinical trial costs incurred by the Company decreased to $3.33 million in 2003 from $9.64 million in 2002.

Pre-clinical costs

Pre-clinical trial costs in 2003 declined compared to 2002 as the majority of the required ISA247 toxicology and efficacy pre-clinical studies were completed in 2002. The Company incurred pre-clinical costs for new toxicology studies in 2003 for TAFA-93. Pre-clinical costs relate primarily to toxicology studies and the frequency of these types of studies decrease as the Company moves into the human clinical trial program. The Company expects pre-clinical costs to continue as the Company moves its two new drug compounds, TAFA-93 and TKB662, through the pre-clinical phase.

Technical, analytical and drug supply

Technical, analytical and drug supply in 2003 decreased to $3.42 million from $5.59 million in 2002. Included in the 2002 costs, were charges of $3.34 million for ISA247 drug supply from a contract manufacturer, whereas Roche became responsible for the ISA247 manufacturing upon signing of the Collaboration Agreement. Offsetting this reduction in 2003 were the development costs of TAFA-93 and TKB662 including the cost of raw material for TAFA-93.

Infrastructure and other support costs

Infrastructure costs include the direct costs of the R&D facilities, such as rent, utilities and building maintenance and other support costs related to R&D activities such as equipment maintenance and repair. These costs increased significantly as a result of the new lab facilities in both Edmonton and Arizona. The Company anticipates costs in 2004 to be consistent with that incurred in 2003.

Net development costs charged by (recovered from) collaboration partner

Under the cost sharing arrangement with Roche, as discussed in the ISA247 development section, Isotechnika was responsible for 30%, on a combined basis, of the shared ISA247 development costs with Roche responsible for the remaining 70%. The Collaboration Agreement with Roche allowed Isotechnika to significantly reduce ISA247 development costs from what it otherwise would have had to incur if it had been paying 100 % of these development costs.

For 2003, the Company recorded a recovery of R&D costs of $4.16 million from Roche for their 70% share of the ISA247 development costs incurred by Isotechnika. The Company also recorded a charge of $4.32 million from Roche for Isotechnika's 30% share of the development costs incurred by Roche. The majority of these costs related to the optimization of the manufacturing and formulation processes and to produce the drug supply. These costs were netted and shown as development costs paid to (received from) collaboration partner on the financial statements. In 2003, this resulted in a net development cost charged by collaboration partner of $165,000 compared to a net development cost recovered from collaboration partner of $10.09 million in 2002.

Corporate, Administration and Marketing

The changes in corporate, administration and marketing for the year ended December 31, 2003 compared to the year ended December 31, 2002 are as follows:

Corporate, Administration and Marketing Expenditures (in thousands of dollars)	2003	2002	Increase
	$	$	$
Infrastructure and other support costs	6,665	6,105	560
Investor relations & public company related costs	1,231	872	359
Professional fees	1,022	841	181
Total	8,918	7,818	1,100

Infrastructure and other support costs include executive salaries and bonuses for corporate, administration and marketing activities, business development, administrative and marketing personnel salaries and benefits; director fees, travel, promotion and business development expenditures; corporate and administration facility costs such as rent, information technology and general office expenditures. The increase in infrastructure and other support costs was attributable, in part, to an increase in non-management director fees to $608,800 in 2003 from $70,600 in 2002. In 2003, non-management directors received their annual director fee compensation in cash compared to a combination of cash and stock options in 2002. Personnel costs also increased due to both an increase in the number of staff members and salary increases awarded to staff. Infrastructure and other support costs are anticipated to decrease in 2004 when compared to the 2003 amounts. Non management director fees have been reviewed for 2004 and have been forecast to decrease to approximately $350,000. In addition, the Company has forecast reduced travel and promotion costs for 2004 from that incurred in 2003.

Investor relations and public company related costs include such costs as TSX filing fees, annual report and annual general meeting costs, and investor relations activities. The increase in costs in this category of $359,000 was primarily the result of hiring a U.S. based investor relations/public relations firm and incurring other consulting services to expand the Company's profile in both the United States and in Europe.

Professional fees include fees for legal, audit, tax, and various other consulting services. The increase in professional fees resulted from additional tax advice fees to complete a transfer pricing study and higher consulting fees paid to a director for legal and consulting services rendered as indicated in the related party section of this report.

Amortization

Amortization expense was $1.80 million for the year ended December 31, 2003 compared to $1.07 million for 2002. The increase in amortization expense reflects the amortization of leasehold costs associated with the Company's new laboratory facility in Edmonton, Alberta; the new leased office/lab site in Arizona; and equipment additions made in 2002 and 2003.

Stock-based Compensation Expense

As of January 1, 2003, the Company adopted the new accounting standard for stock-based compensation. As such, new awards of stock options commencing January 1, 2003 are accounted for in accordance with the fair value method of accounting for stock-based compensation and result in compensation expense over the period in which the related services are rendered.

In the second quarter ended June 30, 2003 the Company granted 790,000 new stock options. The Company used the Black-Scholes option pricing model to estimate the fair value of the options granted. Of the 790,000 options granted, 590,000 vested immediately while the remaining 200,000 options vest at variable intervals over the next two years. Application of the fair value method resulted in a $714,000 charge to stock based compensation expense with a corresponding charge to contributed surplus for the year ended December 31, 2003.

Other Income (Expenses)

Investment Income

	2003	2002	Decrease
(in thousands of dollars)	$	$	$
Investment income	1,545	1,688	(143)

Investment income is composed of interest earned on cash and cash equivalents, interest earned on the bond (short-term investment) portfolio less the bond amortization on any discount (premium) paid on the purchase of the bonds, plus any gains (losses) realized on the disposal of cash equivalents and short-term investments (such as money market funds and bonds).

Investment income for the year ended December 31, 2003 was $1.55 million compared to $1.69 million for 2002. The decrease in investment income for 2003 was the result of lower returns on investments available in the marketplace. Cash and short-term investments held by the Company increased in 2003 as a result of receiving a $21.9 million milestone payment from Roche in June 2003 and completing a US private placement for net proceeds of $19.03 million on July 17, 2003. The increase in the cash and short-term investment balances offset to some degree, the reduction in interest rate return realized in 2003. The Company anticipates that investment income will continue to fluctuate in relation to cash and short-term investment balances and interest yields.

Foreign Exchange gain(loss)

	2003	2002	Decrease
(in thousands of dollars)	$	$	$
Foreign exchange gain(loss)	(5,772)	250	(5,927)

The Company's functional currency is the Canadian dollar. The Company recorded a foreign exchange translation loss of $5.77 million for the year ended December 31, 2003 compared to a gain of $250,000 for 2002. Of the $5.77 million foreign exchange loss recorded in 2003, $4.56 million was unrealized at December 31, 2003. The loss incurred in 2003 was primarily a result of unrealized foreign exchange losses

on US dollar denominated holdings of cash and cash equivalents and short-term investments. The holdings of US denominated funds increased during the year as the Company completed a US private placement for gross proceeds of $15 million USD on July 17, 2003. It also received the milestone payment from Roche in US dollars in the second quarter of 2003. The foreign exchange loss for 2003 reflects the significant appreciation of the Canadian dollar against the US dollar during 2003. The Company has not hedged its foreign currency position as it requires US funds for its US operations and to pay for transactions denominated in US funds. The Company is maintaining its holdings of US dollars in anticipation of incurring US dollar research and development expenditures for future clinical trials. Future transactions conducted in US funds will cost less when converted to Canadian dollars due to the appreciation of the Canadian dollar against the US dollar and as such will offset the unrealized foreign exchange losses currently being recorded. Therefore, the foreign exchange loss, while significant from an accounting point of view, does not affect the Company's ability to pay US dollar denominated expenditures. Future exchange losses or gains will be determined on the fluctuation of the Canada-US exchange rates.

The following table presents the unaudited selected financial data for each of the last eight quarters ended December 31, 2003.

	Year ended December 31,2003				Year ended December 31,2002			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	(in thousands of dollars, except for earnings(loss) per share)							
Revenues	317	8,795	415	408	3,513	8,275	6,648	325
Net earnings(loss)	(5,944)	1,530	(6,253)	(8,326)	(3,307)	3,180	3,952	(4,401)
Basic and diluted earnings(loss) per share	(0.09)	0.02	(0.08)	(0.11)	(0.05)	0.05	0.06	(0.07)

Isotechnika is a research and development company, with its primary focus being the development and commercialization of immunosuppressive drug compounds. As such, given the stage of development of the Company's drug compounds, the Company's focus is not earnings (loss) per share, but rather that the Company has adequate financial resources to fund the research and development programs it conducts. As discussed more fully in the liquidity section of this document, the Company believes it currently has adequate financial resources for at least the next two years.

The quarterly results of the Company have fluctuated primarily as a result of the milestones received by the Company from its collaboration partner, Roche. In 2003, the results have also been impacted by foreign exchange losses recorded due to significant appreciation of the Canadian dollar compared to the U.S. dollar.

In the 4th quarter of 2003, the Company incurred a loss of $8.33 million or $0.11 per share as compared to loss of $4.40 million or $0.07 per share. The Company recorded a $1.95 million foreign exchange loss in the 4th quarter of 2003 compared to gain of $141,000 for the 4th quarter of 2002. Net research and development also increased by $1.05 million as the Company incurred pre-clinical costs for the new drug candidates, TAFA-93 and TKB662 and recorded higher costs related to its 30% share of ISA247 development costs incurred directly by Roche.

CAPITAL EXPENDITURES

Capital expenditures on property and equipment were $3.98 million for the year ended December 31, 2003 compared to $8.59 million for the year ended December 31, 2002. Capital expenditures incurred during the year ended December 31, 2003 included $1.85 million in scientific equipment. A $400,400 Sciex triple quad mass spectrometer unit purchased under a capital lease arrangement, and reflected as an obligation under capital lease on the balance sheet, was the largest scientific piece of equipment acquired.

In addition, the Company incurred leasehold improvement costs of $1.60 million to complete the Edmonton laboratory facility and the combined Arizona office and laboratory site. The Company received tenant inducements of $536,000 to offset the cost of leasehold improvements. As of December 31, 2003, $469,000 of the original amount has been recorded as deferred tenant inducements on the balance sheet and will be amortized over the lease terms.

Currently the Company has no significant commitments for property and equipment expenditures for 2004. The Company has forecast that property and equipment expenditures for 2004, based on current needs, should be in the range of approximately $1.0 million. These purchases will be funded from working capital and/or capital leases.

Capital expenditures incurred for patents in 2003 amounted to $480,000 compared to $701,000 in 2002 and are comprised of fees paid to patent offices worldwide and to external patent counsel. A significant portion of these costs incurred in 2003 were for ISA247 patent applications and filings. These costs are amortized over a period of fifteen years upon receiving the patent. Capitalized patent costs are reviewed annually to determine if there has been an impairment of value. To date, the Company has received 29 patents for its various technologies and has 210 patent applications pending. In 2003, the Company received seven new patents, including two United States patents for ISA247, and filed eight new patent applications.

The Company will continue to incur significant patent costs in 2004 and future years to secure its technologies. The Company has created a patent department with three people to internally process patent applications and required filings where possible. These internal costs have been, and will continue to be, expensed as research and development costs as they are incurred. However, the Company still expects to incur significant third party legal fees and patent filing fees, particularly with the international filings for ISA247 in 2004. These external expenditures will continue to be capitalized. Patent costs will be funded from working capital.

LIQUIDITY AND CAPITAL RESOURCES

Since the Company's inception, it has been financed primarily from public and private sales of equity, the exercise of warrants and stock options and interest earned on cash and cash equivalents and short-term investments.

On July 17, 2003, the Company closed a private placement with US based institutional investors, which resulted in the issue of 6,465,755 common shares at a price of $3.23 per common share for net proceeds of $19.03 million (net of agent's commissions and issue costs of $1.85 million).

In June 2003, the Company issued 3,010,033 common shares to its collaboration partner, Roche, at $4.50 per share for gross proceeds of $13.54 million. The Company achieved a significant scientific milestone pursuant to the terms of the Collaboration Agreement with Roche as discussed previously in the overview section of this document.

During the year ended December 31, 2003 the Company also issued 305,800 common shares for proceeds of $550,000 on the exercise of 305,800 employee stock options.

On September 26, 2002 the Company received approval for a Normal Course Issuer Bid allowing the Company to repurchase up to 2 million common shares, of its issued and outstanding common shares during the period September 30, 2002 to September 29, 2003, at market price at the time of the purchase. For the period January 1, 2003 to September 29, 2003, the expiry date of the bid, the Company repurchased 226,500 shares for $680,000 at an average cost of $3.00 per share.

On September 30, 2003 the Company received approval for an extension to the Normal Course Issuer Bid allowing the Company to repurchase up to 2 million shares during the period September 30, 2003 to September 29, 2004, at market price at the time of the purchase. For the period October 1, 2003 to December 31, 2003, the Company repurchased 47,800 shares for $153,000 or an average cost of $3.19 per share.

As a result of the above noted transactions, the Company had 74.77 million shares issued and outstanding as at December 31, 2003 compared to 65.26 million as at December 31, 2002. The number of options and warrants outstanding at year end is 7.1 million and could generate $25.3 million if exercised.

At December 31, 2003 the Company had cash and cash equivalents and short-term investments of $81.5 million compared to $64.2 million as at December 31, 2002. The increase in the cash and cash equivalents and short-term investment position of the Company was largely attributed to the $21.9 million milestone payment from Roche and the net proceeds of $19.03 million from the US private placement. The Company's short-term investments are comprised of liquid government and corporate debt instruments having a triple "BBB" credit rating or greater.

The Company is exposed to market-rate risk related to changes in interest rates and foreign exchange rates between the Canadian and US dollar, which could affect the value of the cash equivalents and short-term investments. The Company does not believe that the results of operations or cash flows would be affected to any significant degree by a sudden change in market interest rates relative to our investments, due to relative short-term nature of the investments, which do not have maturities greater than three years.

The Company has debt related to the purchase of equipment. The Company has two capital leases outstanding as at December 31, 2003. These leases were entered into to finance the purchase of two Sciex mass spectrometer units. One unit was purchased in each of 2003 and 2002.

The long term debt and obligations under capital leases and the operating obligations are as follows:

(in thousands of dollars)	Total	<one year	1-3 years	>3 years
Long-term debt and obligations under capital leases	619	281	289	49
Operating lease obligations	3,686	761	1,384	1,541
Purchase obligations	1,374	1,374	-	-

RELATED PARTY TRANSACTIONS

Included in Prepaid expenses and other is a loan receivable from an officer and a director in the amount of $189,000 (2002-$189,000). The loan, effective January 1, 2003 bears interest at 5% per annum and is unsecured. The term of the loan has been extended to December 31, 2004 from December 31, 2003.

Included in corporate, administration and marketing expense are legal and consulting fees to a director in the amount of $198,450 (2002-$117,750). These services are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

RISK AND UNCERTAINTIES

Management believes that the Company's current financial position will be sufficient to meet working capital and capital requirements for at least the next two years. Isotechnika's funding needs may, however, vary depending upon a number of factors including progress of the Company's research and development programs, the number and breadth of these programs, the costs associated with completing future clinical trials and the regulatory process, collaborative and license agreements with third parties, Isotechnika's potential decision to in-license or acquire additional products for development and defending or enforcing Isotechnika's patent claims and other intellectual property rights. In the future, Isotechnika may need to raise additional funds to continue its research and development programs and to commence or continue the pre-clinical and clinical trials needed to obtain regulatory and marketing approvals. There can be no assurance that such funds will be available on favorable terms, or at all.

The Company's drug products are at a development stage. As such, they have not been approved by regulatory authorities in any relevant jurisdiction and have not yet been marketed commercially. The future performance of Isotechnika will be impacted by a number of important factors, including in the short-term, its ability to continue to generate cash flow from equity financings and the status of its Collaboration Agreement with Roche, and longer term, its ability to generate royalty or other revenues from licensed technology and bring new products to the market. The Company's future success will require efficacy and safety of its products and regulatory approval for these products. Future success of commercialization of any product is also dependent on the ability of the Company to obtain patents, enforce such patents and avoid patent infringement.

The Company maintains clinical trial liability and product liability insurance; however, it is possible this coverage may not provide full protection against all risks.

The Company's investment earnings are exposed to financial market risks arising from volatility in interest and foreign currency exchange rates. The Company has exposure to exchange risk as it holds a portion of its cash and short-term investments in US denominated funds. As at December 31, 2003, US denominated cash and cash equivalents and short-term investments amounted to $36.5 million Cdn. The Company does not engage in additional hedging or use derivatives to reduce foreign currency risk.

Isotechnika's share price is subject to equity market price risk, which may result in significant speculation and volatility of trading due to the uncertainty inherent in the Company's business in the biotechnology industry. The expectations of securities analysts about the Company's financial or scientific results could have a significant effect on the trading price of the Company's shares.

A detailed list of the risks and uncertainties affecting Isotechnika can be found in the Company's Annual Information Form.

Additional information relating to Isotechnika, including the Company's Annual Information Form is available on SEDAR at www.sedar.com or at the Company's web site at www.isotechnika.com

OUTLOOK

The Company expects to incur operating losses for 2004 and future years as the development of the Company's drug compounds continues. Net research and development costs are expected to increase in 2004 from those incurred in 2003 as the Company advances ISA247 into the further human clinical trials. Additional research and development expenditures are also forecast to be incurred in completing the pre-clinical studies for TAFA-93 and TKB662 and moving these drug compounds into Phase I human clinical trials. Additional clinical trials will also be performed on the Company's new diagnostic breath kit, the Diatest®, to further validate the kit and provide the necessary clinical data for marketing the kit initially in Canada and ultimately to other countries, including the United States.

The Company as at December 31, 2003 had $81.5 million in cash and cash equivalents and short-term investments. As such, the Company believes it has sufficient resources to fund planned operations for at least the next two years.

Over the longer term, the Company expects that it will require additional financing and as such plans to raise funds from time to time through either the capital markets or strategic partnering initiatives. Funding requirements may vary depending on a number of factors, including the progress and results of the pre-clinical studies and human clinical trials, regulatory approvals, and competing technological and market developments. Depending on the results of the research and development programs and availability of financial resources, the Company may accelerate, terminate, cut back on certain areas of research and development, or commence new areas of research and development.

FORWARD-LOOKING STATEMENTS

Except for historical information, "This Management's Discussion and Analysis of Financial Condition and Operations" contains forward-looking statements which may not be based on historical fact. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, events or developments to be materially different from any future results, events or developments expressed or implied by such forward-looking statements. Such factors include, among others, risks associated with the completion of clinical trials and obtaining regulatory approvals, the ability to protect the Company's intellectual property, dependence on its collaborative partner, additional long-term capital requirements and Isotechnika's stage of development. These factors should be considered carefully and readers are cautioned not to place undue reliance on such forward-looking statements.

MANAGEMENT REPORT

The accompanying consolidated financial statements of **Isotechnika Inc.** and all information in the annual report are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. The financial statements include some amounts that are based on best estimates and judgements of management. Financial information used elsewhere in this annual report is consistent with that in the financial statements.

Management of the Company maintains a system of internal controls to provide reasonable assurance as to the reliability of financial information and the safeguarding of assets.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal controls principally through its Audit Committee. The Audit Committee is appointed by the Board and consists of three members, all of whom are not involved in the daily operations of the Company. The Committee meets quarterly with the management and the external auditors to discuss internal controls over the financial reporting process and financial reporting issues, to make certain that each party is properly discharging its responsibilities and to review quarterly reports, the annual report and the annual financial statements. The Committee reports its findings to the Board for consideration when approving the financial statements for issuance to the shareholders. The Company's auditors have full access to the Audit Committee, with and without management being present.

These financial statements have been audited by the Company's auditors, PricewaterhouseCoopers LLP.

Robert Foster, Ph.D.
Chairman and Chief Executive Officer

Dennis Bourgeault, C.A.
Chief Financial Officer

AUDITORS' REPORT TO THE SHAREHOLDERS OF ISOTECHNIKA INC.

We have audited the consolidated balance sheets of **Isotechnika Inc.** as at December 31, 2003 and 2002 and the consolidated statements of operations, deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
February 12, 2004
Edmonton, Canada

Isotechnika Inc.

Consolidated Balance Sheets

As at December 31, 2003 and 2002

(expressed in thousands of Canadian dollars)

	2003 $	2002 $
Assets		
Current assets		
Cash and cash equivalents	35,822	31,252
Short-term investments	45,680	32,952
Accounts receivable (note 5)	374	3,512
Inventories (note 6)	728	813
Prepaid expenses and other	535	471
	83,139	69,000
Property and equipment (note 7)	11,156	8,993
Patents (note 8)	2,229	1,791
	96,524	79,784
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 9)	6,619	4,503
Current portion of long-term debt and obligations under capital leases (note 10)	242	206
Current portion of deferred lease inducements	91	-
	6,952	4,709
Long-term debt and obligations under capital leases (note 10)	309	203
Deferred lease inducements	378	-
	7,639	4,912
Commitments (note 11)		
Shareholders' Equity		
Share capital (note 12)	139,838	107,184
Contributed surplus (note 12)	714	-
Deficit	(51,667)	(32,312)
	88,885	74,872
	96,524	79,784

(The accompanying notes are an integral part of these financial statements)

Approved by the Board

Donald Schurman
Director

M. Douglas Walker
Director

Isotechnika Inc.

Consolidated Statements of Deficit

For the years ended December 31, 2003 and 2002

(expressed in thousands of Canadian dollars)

	2003 $	2002 $
Balance – Beginning of year	32,312	31,591
Net loss for the year	18,993	576
Cost of common shares repurchased in excess of stated capital	362	145
Balance – End of year	51,667	32,312

(The accompanying notes are an integral part of these financial statements)

Isotechnika Inc.

Consolidated Statements of Operations

For the years ended December 31, 2003 and 2002

(expressed in thousands of Canadian dollars, except per share amounts)

	2003 $	2002 $
Revenue		
Revenue from collaboration partner (note 2)	8,355	14,097
Contract analysis and product sales	1,580	1,484
Review and option fees (note 2)	-	3,180
	9,935	18,761
Expenses		
Research and development	11,666	21,281
Net development costs charged by (recovered from) collaboration partner (note 2)	165	(10,094)
	11,831	11,187
Corporate, administration and marketing	8,918	7,818
Amortization	1,800	1,072
Contract analysis and product sales	1,173	1,080
Stock-based compensation (note 12)	714	-
Interest on long-term debt and obligations under capital leases	45	33
	24,481	21,190
Loss before the undernoted	(14,546)	(2,429)
Other income (expenses)		
Investment income	1,545	1,688
(Loss) gain on disposal of property and equipment	(56)	28
Realized foreign exchange translation (loss) gain	(1,215)	-
Unrealized foreign exchange translation (loss) gain	(4,557)	250
	(4,283)	1,966
Net loss before capital taxes	(18,829)	(463)
Capital taxes (note 14)	164	113
Net loss for the year	(18,993)	(576)
Basic and diluted loss per share (note 13)	(0.27)	(0.01)

(The accompanying notes are an integral part of these financial statements)

Isotechnika Inc.

Consolidated Statements of Cash Flows

For the years ended December 31, 2003 and 2002

(expressed in Canadian dollars, in thousands)

	2003 $	2002 $
Cash provided by (used in)		
Operating activities		
Net loss for the year	(18,993)	(576)
Items not affecting cash		
Amortization of property, equipment and patents	1,800	1,072
Unrealized foreign exchange translation loss (gain)	4,557	(250)
Stock-based compensation	714	-
Loss (gain) on sale of property and equipment	56	(28)
Amortization of deferred lease inducements	(67)	-
	(11,933)	218
Net change in other operating assets and liabilities (note 17)	5,275	(1,806)
	(6,658)	(1,588)
Investing activities		
Increase in short-term investments	(12,728)	(28,713)
Unrealized foreign exchange translation loss on short-term investments	(2,552)	-
Purchase of property and equipment	(2,931)	(6,839)
Proceeds on sale of property and equipment	-	764
Patents	(480)	(701)
	(18,691)	(35,489)
Financing activities		
Issuance of share capital, net of share issue costs	33,123	19,601
Purchase of share capital	(831)	(323)
Repayment of long-term debt and capital leases	(368)	(236)
	31,924	19,042
Effect of foreign exchange rate fluctuation on cash and cash equivalents	(2,005)	250
Increase (decrease) in cash and cash equivalents	4,570	(17,785)
Cash and cash equivalents – Beginning of year	31,252	49,037
Cash and cash equivalents – End of year	35,822	31,252
Cash and cash equivalents are comprised of		
Cash on deposit	12,836	9,748
Money market securities and investment deposits	22,986	21,504
	35,822	31,252

Supplemental disclosures of cash flow information (note 17)

(The accompanying notes are an integral part of these financial statements)

1 Nature of operations

Isotechnika Inc. (the "Company"), incorporated under the Business Corporations Act of Alberta, is an international biopharmaceutical company, which is in the business of developing immunosuppressive drugs for the prevention of organ rejection and for treatment of autoimmune diseases. It also develops, licenses and sells diagnostic products and services.

2 Development Collaboration and Licensing Agreement

On April 9, 2002, the Company entered into a Development Collaboration and Licensing Agreement (the "Collaboration Agreement") with F. Hoffmann-La Roche Ltd. and Hoffmann-La Roche Inc. (collectively "Roche") for the global co-development and commercialization of the Company's innovative immunosuppressive drug ISA247. Under the terms of the Collaboration Agreement, Roche has the worldwide exclusive right to manufacture, market and sell the ISA247 product. The terms of the Collaboration Agreement provide for equity investments, milestone payments and sales based payments.

On February 5, 2002, the Company signed an option agreement with Roche. As consideration for Roche to exercise its option to engage in advanced partnership discussions and enter an exclusive 45-day period to negotiate a definitive joint drug development agreement with the Company, Isotechnika received a $3,180,000 option fee, which has been recorded as review and option fees revenue. The Company also received, under the terms of a subscription agreement between Roche and the Company, an equity investment from Roche of $4,755,000 by the issuance of 1,188,675 common shares at $4.00 per common share.

Pursuant to the execution of the Collaboration Agreement with Roche, the Company received an initial fee of $7,817,000. The Company also received, pursuant to the terms of a share subscription agreement with Roche, an additional equity investment of $13,545,000 from Roche by issuing 3,187,200 common shares at $4.25 per common share. In conjunction with the share subscription agreement, the Company issued 3,010,033 warrants entitling Roche to acquire one common share per warrant at an exercise price of $4.50 per share.

In September 2002, the Company achieved a scientific milestone under the terms of the Collaboration Agreement for the successful completion of a non-human toxicity study. The Company received a $6,280,000 payment for this milestone.

On May 15, 2003, the Company achieved another scientific milestone pursuant to the terms of the Collaboration Agreement. The results of the completed Phase II clinical trial of ISA247 in patients with moderate to severe psoriasis met the milestone requirements of the agreement and accordingly, entitled the Company to receive a milestone payment of $21,900,000. The cash payment was comprised of $8,355,000, which was recorded as revenue from collaboration partner and $13,545,000 in equity investment. The Company issued 3,010,033 common shares at $4.50 per share upon the exercise of 3,010,033 warrants by Roche.

The initial fee and milestone payments have been recorded as revenue from collaboration partner. As the ratio of costs expended to total estimated development costs exceeded the ratio of revenue from the initial fee and milestone, to total initial and milestone fees under the agreement, none of the revenue was deferred.

Under the terms of the Collaboration Agreement related to funding of ISA247 development costs, Roche is responsible for 70% and Isotechnika is responsible for 30% of eligible development costs incurred by both Roche and Isotechnika as defined in the Collaboration Agreement. The Company and Roche reconcile joint development costs on a quarterly basis. The Company nets its overall share of the ISA247 development costs and records the net amount as net development costs charged by (recovered from) collaboration partner.

	2003 $	2002 $
Charge from collaboration partner for 30% of shared ISA247 costs incurred by collaboration partner	4,320	1,748
Recovery of 70% of shared ISA247 costs incurred by Isotechnika Inc. from collaboration partner	(4,155)	(11,842)
Net development costs by (recovered from) collaboration partner	165	(10,094)

3 Significant accounting policies

Use of estimates

The consolidated financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada. Because the precise determination of certain assets and liabilities is dependent upon future events, the preparation of these consolidated financial statements necessarily includes the use of estimates and approximations, which have been made using careful judgment. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been prepared within reasonable limits of materiality and within the framework of the accounting policies summarized below.

Basis of consolidation

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Isodiagnostika Inc., Isotechnika US Inc., Isotechnika International Inc. and Isoleasing Inc. All intercompany balances and transactions have been eliminated upon consolidation.

Translation of foreign currencies

Foreign subsidiaries are considered financially and operationally integrated and are translated using the temporal method. The monetary assets and liabilities of Canadian operations and integrated foreign operations are translated into Canadian dollars at rates of exchange in effect at the end of the year. Revenues and expenses are translated at average rates of exchange during the year, except for the amortization of property and equipment and patents, which are translated at historical rates of exchange. Non-monetary assets and liabilities of integrated foreign operations are translated at historical rates of exchange. Exchange gains and losses arising on translation are included in earnings.

Revenue recognition

Revenue from contract analysis and product sales is recognized upon performance of the service or delivery of the product when persuasive evidence of an arrangement exists, the price is fixed or determinable and collection is reasonably assured.

Revenue from collaboration partner is recorded in accordance with the contingency-adjusted performance model. Payments received under this type of arrangement may include the following: non-refundable fees at the inception of the contract for prior research and technology rights; funding for services performed; milestone payments for specific achievements; and, payments based upon resulting sales of products. The Company recognizes collaborative research and development revenues as services are performed consistent with the performance requirements of the contract. Revenue from non-refundable contract fees is deferred and recognized ratably over the development period based on the ratio of costs expended to total estimated development costs. Revenue from performance milestones is recognized upon achievement of the milestones as specified in the agreement, provided payment is proportionate to the effort expended as measured by the ratio of costs expended to total estimated development costs. The period and estimated cost of development are reviewed on a regular basis.

Review and option fees consist of deposits received in conjunction with intellectual property reviews by potential partners. These deposits are deferred until it is confirmed that they are not refundable.

Cash and cash equivalents

Cash and cash equivalents consist of cash on deposit and highly liquid money market securities and investment deposits, which are readily convertible into cash.

Short-term investments

Short-term investments, which are liquid bond investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk for changes in value, are carried at the lower of amortized cost plus accrued interest and market value. Gains and losses on disposal of short-term investments are included in investment income in the period of realization. Premiums or discounts are amortized over the remaining maturity of the instrument and reported in investment income in the consolidated statement of operations.

Inventories

Inventories consist of diagnostic products and are recorded at the lower of cost, on a specific item basis or first in, first out basis depending on the nature of the item, and net realizable value.

Property and equipment

Property and equipment are recorded at cost. Amortization is provided over the estimated useful lives of the assets using the straight-line method at the following annual rates:

Building	5%
Leasehold improvements	Term of the lease
Airplane fractional ownership interest	10%
Scientific equipment	20%
Scientific equipment under capital lease	Term of the lease
Office equipment and furniture	20%
Computer equipment and software	33.3%
Automotive equipment	20%

Patents

Capital expenditures incurred for patents are comprised of fees paid to patent offices worldwide and to external patent counsel on specific patent applications. If the patent application is successful, costs incurred on that application are amortized straight-line over a fifteen-year useful life, commencing in the year of the grant of the patent. If a patent application is rejected or the specific technology is no longer considered commercially viable, the costs incurred on that application are expensed at that time.

In-house patent expenditures including wages and benefits are recorded as research and development expenses on the statement of operations as incurred.

Lease inducements

The Company received lease inducements in the form of leasehold improvements. These inducements have been deferred and are applied against the rent expense of future periods over the term of the lease.

Research and development

Research costs are expensed in the period incurred. Development costs are also expensed in the period incurred unless technical and market viability of a development project has been established. No development costs have been deferred to date.

Under the terms of the Collaboration Agreement related to funding of ISA247 development costs, Roche is responsible for 70% and Isotechnika is responsible for 30% of eligible development costs incurred by both Roche and Isotechnika as defined in the Collaboration Agreement.

Net development costs recovered from collaboration partner are offset against research and development expenses.

Future income taxes

The Company follows the liability method of income tax allocation. Under this method, future income taxes are recognized for the future income tax consequences attributable to differences between the carrying values of assets and liabilities and their respective income tax basis. Future income tax assets and liabilities are measured using substantively enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in rates is included in earnings in the period that includes the date of substantial enactment. Future income tax assets are recorded in the financial statements if realization is considered more likely than not.

Loss per share

Loss per share is based on the weighted average number of common shares outstanding during the year. Diluted earnings (loss) per share is calculated using the treasury stock method. Under the treasury stock method deemed proceeds from the exercise of options and warrants whose exercise prices are below the average market price of the shares, are considered to be used to reacquire common shares at the average market price during the year.

4 Change in accounting policy

Effective January 1, 2003, the Company adopted the new Canadian accounting standard for stock-based payments to employees. As such, new awards of stock options to employees made on or after January 1, 2003 are accounted for in accordance with the fair value method of accounting for stock-based compensation and result in compensation expense and contributed surplus. The amount of compensation is measured at the date the option is granted. The expense is recognized in income over the service period of the employee to whom the option was granted. Any consideration paid on exercise of stock options is credited to share capital. Previously, the Company did not record any compensation expense upon the issuance of stock options. This change in recording the fair value of awards has been applied on a prospective basis for awards granted on or after January 1, 2003 and has resulted in the recognition of $714,000 of compensation expense for the year ended December 31, 2003.

5 Accounts receivable

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Trade receivables	192	230
Commodity taxes receivable	171	283
Other	11	44
Receivable from collaboration partner	-	2,955
	374	3,512

6 Inventories

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Raw materials	237	239
Work in process	73	72
Finished goods	418	502
	728	813

Inventories consist of diagnostic products.

7 Property and equipment

	2003		
	Cost $	Accumulated amortization $	Net $
		(in thousands of Canadian dollars)	
Building and leasehold improvements	6,714	682	6,032
Scientific equipment	3,327	1,243	2,084
Scientific equipment under capital lease	843	221	622
Airplane fractional ownership interest	1,987	274	1,713
Office equipment and furniture	783	305	478
Computer equipment and software	704	477	227
Automotive equipment	30	30	-
	14,388	3,232	11,156

	2002		
	Cost $	Accumulated amortization $	Net $
		(in thousands of Canadian dollars)	
Building and leasehold improvements	5,111	171	4,940
Scientific equipment	1,701	790	911
Scientific equipment under capital lease	575	108	467
Airplane fractional ownership interest	1,987	75	1,912
Office equipment and furniture	649	162	487
Computer equipment and software	556	285	271
Automotive equipment	30	25	5
	10,609	1,616	8,993

During the year, amortization of $1,758,000 (2002 – $794,000) was recorded.

8 Patents

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Cost of patent applications	2,730	2,250
Less: Accumulated amortization	501	459
	2,229	1,791

During the year, amortization of $42,000 (2002 – $278,000) was recorded.

9 Accounts payable and accrued liabilities

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Payable to collaboration partner	4,732	-
Trade payables	1,155	2,188
Accrued liabilities	732	1,007
Construction payable	-	1,308
	6,619	4,503

10 Long-term debt and obligations under capital leases

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Various leases with combined monthly payments of $23,248, due from April 1, 2005 to April 1, 2007, collateralized by specific equipment with a net book value of $622,000 (2002 – $467,000)	549	399
Finance contract, payable in monthly instalments of $684 including interest at .99%, collateralized by automotive equipment with a net book value of $nil, due March 10, 2004	2	10
	551	409
Less: Current portion	242	206
	309	203

Future minimum lease payments required to retire the lease obligations and debt are as follows:

	2003 $	2002 $
	(in thousands of Canadian dollars)	
2003	-	227
2004	281	162
2005	172	54
2006	117	-
2007	49	-
	619	443
Less amounts representing interest at rates ranging from 8.44% to 9.67%)	68	34
	551	409

Interest expense on capital leases in the amount of $45,000 (2002 – $33,000) has been recorded on the statement of operations.

11 Commitments

Operating lease commitments

Future minimum lease payments required in total are approximately $3,686,000 and lease payments required in each of the next five years under operating leases for premises and equipment are as follows:

	$
2004	761,000
2005	704,000
2006	680,000
2007	384,000
2008	248,000

12 Share capital

Authorized
Unlimited number of common, voting shares

Issued and outstanding

	Common shares		Warrants		Total
	#	$ (in thousands of Canadian dollars)	#	$ (in thousands of Canadian dollars)	$ (in thousands of Canadian dollars)
Balance – December 31, 2001	60,331,779	87,761	285,000	-	87,761
Shares issued in private placement to Roche (note 2)	1,188,675	4,755	-	-	4,755
Shares and warrants issued in private placement to Roche (note 2)	3,187,200	12,016	3,010,033	1,529	13,545
Shares issued on exercise of stock options	661,250	1,592	-	-	1,592
Shares repurchased and cancelled	(109,200)	(178)	-	-	(178)
Share issue costs	-	(291)	-	-	(291)
Balance – December 31, 2002	65,259,704	105,655	3,295,033	1,529	107,184
Shares issued on exercise of stock options	305,800	550	-	-	550
Warrants exercised	3,010,033	15,074	(3,010,033)	(1,529)	13,545
Shares repurchased and cancelled	(274,300)	(469)	-	-	(469)
Private placement	6,465,755	17,934	1,293,147	1,094	19,028
Expiry of compensation warrants	-	-	(285,000)	-	-
Balance – December 31, 2003	74,766,992	138,744	1,293,147	1,094	139,838

Private Placement

On July 17, 2003, the Company closed a private placement with US based institutional investors, which resulted in the issue of 6,465,755 common shares at a price of $3.23 per common share for net proceeds of $19,028,000 (net of agent's commissions and issue costs of $1,856,388). The common shares were subject to a four-month hold period which expired November 18, 2003.

In addition, under the terms of the offering, the investors also received 1,293,147 warrants on the basis of one warrant for every five common shares acquired. Each warrant entitles the holder to acquire, on or before July 17, 2006, one additional common share at a price of $4.49 per share (which price is subject to anti-dilution protection). In the event Isotechnika's common share trading price on the Toronto Stock Exchange averages $8.98 or higher over 20 consecutive trading days after July 16, 2004, the warrants holders shall be required to exercise their warrants within a 20-day period.

The proceeds from the offering were allocated to the common shares and warrants based on their relative fair values. The fair value attributed to the shares was $23,600,000 and the fair value attributed to the warrants using the Black-Scholes option pricing model was $1,400,000. The assumptions used in the Black-Scholes calculation were:

Annualized volatility	51.5%
Risk-free interest rate	3.3%
Expected life of options in years	3 years
Dividend rate	0.0%

Warrants issued to Collaboration partner

Pursuant to a share subscription agreement between the Company and Roche dated April 9, 2002, the Company issued 3,010,033 warrants to Roche that entitled Roche to acquire one common share per warrant at an exercise price of $4.50 per common share until June 30, 2003. Roche was required to exercise the warrants within 30 days of the Company achieving a specific milestone as specified in the Collaboration Agreement. The fair value attributed to the warrants using the Black-Scholes option pricing model was $1,529,000. The assumptions used in the calculation were:

Annualized volatility	50.9%
Risk-free interest rate	1.3%
Expected life of options in years	1 year
Dividend rate	0.0%

The Company achieved the specific milestone in the second quarter of 2003 and accordingly, 3,010,033 common shares for gross proceeds of $13,545,000 were issued upon conversion of the warrants by Roche.

Escrow agreements

On August 18, 2003, the 4,632,089 common shares held in escrow for regulatory proposes were released.

Normal Course Issuer Bid

On September 26, 2002, the Company received approval for a Normal Course Issuer Bid allowing the Company to repurchase up to 2 million common shares, during the period September 30, 2002 to September 29, 2003 at the market price at the time of the purchase. The Company purchased 226,500 common shares at an average price of $3.00 per share for the period January 1, 2003 to September 29, 2003. The excess of the purchase price over the net book value of the common shares has been charged to the deficit.

On September 20, 2003, the Company received approval for a new normal Course Issuer Bid allowing the Company to repurchase up to 2 million common shares, during the period September 30, 2003 to September 29, 2004 at the market price at the time of the purchase. The Company purchased 47,800 common shares at an average price of $3.19 per share for the September 30, 2003 to December 31, 2003.

All common shares acquired by the Company pursuant to the Normal Course Issuer Bids will be cancelled by Isotechnika Inc. in accordance with the Normal Course Issuer Bid rules.

Stock options and compensation expense

The Company adopted a new employee stock option plan ("New Plan") on April 11, 2003, which was ratified by the shareholders of the Company at the May 21, 2003 annual meeting. This New Plan allows the Company to grant a maximum number of 1,500,000 stock options of which 500,000 were granted on May 26, 2003. These options only be granted to employees of the Company (i.e. excludes officers, directors and consultants). This New Plan was required as substantially all of the options reserved under the original stock option plan had been granted. At December 31, 2003, the maximum number of options available under the New Plan for granting purposes was 1,493,000 of which 491,000 stock options have been granted and are outstanding.

The original stock option plan remains in existence and allows the Company to grant to its directors, officers, employees, scientific advisory board members and consultants non-transferable options for the purchase of common shares. At December 31, 2003, the maximum number of options available under the original plan for granting purposes was 5,574,267 of which 5,322,067 stock options have been granted and are outstanding.

The Company adopted a policy on April 11, 2003, whereby the number of stock options granted by the Company cannot exceed ten percent of the issued common shares.

Both stock option plans require the exercise price of each option be determined by the Board of Director and cannot be less than closing market price of the Company's stock on the day immediately prior to the date of grant. The exercise date of the option may not be later than 10 years from the date it is granted. Any options which are forfeited or expire may be re-granted. The Company sets the vesting periods, if any, at its discretion.

A summary of the status of the Company's stock option plans as of December 31, 2003 and 2002 and changes during the years ended on those dates is presented below:

	2003		2002	
	#	Weighted average exercise price $	#	Weighted average exercise price $
Outstanding – Beginning of year	5,988,567	3.59	5,451,417	3.14
Granted	790,000	3.06	1,600,100	3.79
Exercised	(305,800)	1.80	(661,250)	2.41
Cancelled	(659,700)	3.57	(401,700)	3.89
Outstanding – End of period	5,813,067	3.36	5,988,567	3.59
Options exercisable – End of year	5,340,067	3.32	5,019,567	3.27

The following table summarizes information on stock options outstanding at December 31, 2003:

Options outstanding			Options exercisable
Exercise prices $	Number outstanding #	Weighted-average remaining contractual life (years)	Number outstanding #
0.90	25,000	2.96	25,000
1.06	407,000	1.61	407,000
1.25	5,000	0.30	5,000
1.79	65,000	1.32	65,000
2.99	1,450,867	6.77	1,450,867
3.06	781,000	2.40	603,000
3.20	320,000	0.30	320,000
3.70	1,170,000	3.54	950,000
3.95	100,000	1.08	75,000
4.30	1,091,000	6.68	1,091,000
4.35	148,200	1.37	148,200
4.60	250,000	0.82	200,000
	5,813,067		5,340,067

For the year ended December 31, 2003, the Company granted 790,000 stock options as per the Company's stock option plans. 290,000 stock options were issued to officers and directors at $3.06 from the original stock option plan and 500,000 stock options were issued to employees at $3.06 from the new employee stock option plan.

As indicated in note 4, the Company changed its accounting policy effective January 1, 2003 to record compensation expense on options granted to employees, officers and directors on or after that date. The Company used the Black-Scholes option pricing model to estimate the fair value of the options granted to employees, officers and directors in 2003.

The following weighted average assumptions were used:

Annualized volatility	51.7%
Risk-free interest rate	3.2%
Expected life of options in years	2.5 years
Dividend rate	0.0%

Of the 790,000 options granted, 590,000 vested immediately upon grant while the remaining 200,000 options vest at various intervals over the next two years. The weighted average fair value of options granted during the year was $825,000. Application of the fair value method resulted in a charge to stock based compensation expense of $714,000 for the year ended December 31, 2003 with corresponding charges to contributed surplus.

In 2002, permitted by CICA Handbook Section 3870 Stock-Based Compensation and Other Stock-Based Payments, the Company elected not to recognize compensation expense for stock options that were granted. Of the 1,600,100 options which were granted in 2002, 705,100 of the options vested in 2002, 630,000 vested in 2003 and 265,000 options vest in 2004. The weighted average fair value of the options granted in 2002 was $2,651,500.

If compensation costs had been determined based on the fair value of the options at the grant date, using the Black-Scholes option-pricing model, additional compensation expense would have been recorded in the statement of operations for the periods, with pro forma results as presented below.

	2003 $	2002 $
Net loss for the year	18,993	576
Additional compensation expense	757	1,633
Pro forma net loss	19,750	2,209
Pro forma loss per share	0.28	0.03

The Company used the Black-Scholes option pricing model to estimate the fair value of the options granted. The following weighted average assumptions were used:

Annualized volatility	67.0%
Risk-free interest rate	3.7%
Expected life of options in years	2.7 years
Dividend rate	0.0%

13 Loss per share

	2003 $	2002 $
Loss attributable to common shareholders (numerator)	18,993,000	576,000
	#	#
Weighted average number of common shares outstanding (denominator)	69,919,258	63,747,445
	$	$
Basic and diluted loss per share	(0.27)	(0.01)

14 Income taxes

At December 31, 2003, the Company and its subsidiaries had approximately $26,593,000, of non-capital loss carry forwards and approximately $6,662,000 of federal investment tax credits available to reduce future Canadian income taxes otherwise payable.

The non-capital loss carry forwards expire in years ranging from 2004 to 2010 and the federal investment tax credits expire in years ranging from 2004 to 2013.

Scientific research and experimental development expenditures of $31,232,000 are also available to reduce net income for Canadian tax purposes in future periods. These expenditures may be utilized in any period and may be carried forward indefinitely.

In addition, the Company's U.S. subsidiary has approximately US$469,000 of net operating losses expiring in 2016, which may be used to reduce future US income taxes otherwise payable.

Significant components of the Company's long-term future tax assets and liabilities are as follows:

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Future tax assets		
Research and development deductions and credits	17,474	14,123
Loss carry forwards	9,449	6,023
Unrealized foreign exchange loss	1,577	-
Share issue costs	897	732
Property and equipment	-	37
	29,397	20,915
Valuation allowance	(28,049)	(20,419)
Total future tax assets	1,348	496
Future tax liabilities		
Property and equipment	880	-
Patents costs	435	421
Investments	33	75
Total future tax liabilities	1,348	496
Net future tax assets	-	-

Potential income tax benefits in the amount of $28,049,000 (2002 – $20,419,000) have not been recognized in the accounts as the expectation of their realization did not meet the requirement of "more likely than not" under the liability method of tax allocation.

The reconciliation of income taxes attributable to operations using a 36.74% (2002 – 39.24%) statutory tax rate is as follows:

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Expected recovery at the statutory rate	(6,918)	(182)
Unrecognized deductible temporary differences	6,658	3,035
Non-taxable portion of capital gains	(44)	(2,939)
Capital tax	164	113
Stock compensation and non-deductible expenses	304	86
Total income and capital taxes	164	113

15 Financial instruments

The Company's financial instruments consist of cash and cash equivalents, short-term investments accounts receivable, accounts payable and accrued liabilities, long-term debt and obligations under capital lease.

Fair values

The carrying value of cash and cash equivalents, short-term investments, accounts receivable and accounts payable and accrued liabilities approximate fair value due to the immediate or short-term maturity of these financial instruments. The fair value of the Company's short-term investments is determined by quoted market prices at the balance sheet date. The fair value of the Company's long-term debt and capital lease obligations are estimated based on quoted market prices for same or similar instruments and approximate carrying value.

Interest rate risk

The Company is exposed to interest rate risk arising from fluctuations in interest rates on its cash and cash equivalents, as defined in note 3, and its short-term investments. The Company has considered, but does not use, derivative instruments to reduce its exposure to interest rate risk.

Currency risk

Foreign exchange risk is the risk that variations in exchange rates between the Canadian dollar and the United States dollar will affect the Company's operating and financial results. The Company has earned a significant portion of its revenue and incurs a portion of its expenses in United States dollars and does not use derivative instruments to reduce its exposure to foreign exchange risk. As at December 31, 2003, U.S. denominated cash and cash equivalents and short-term investments amounted to $36,538,000 (2002 – $26,287,000). U.S. denominated accounts receivable amounted to $52,000 (2002 – $3,110,000) and U.S. denominated accounts payable and accrued liabilities amounted to $5,835,000 (2002 – $1,648,000).

Credit risk

The Company is exposed to credit risk in the event of non-performance by customers, but does not anticipate such non-performance. The Company monitors the credit risk and credit rating of customers on a regular basis. The maximum credit risk is the fair value of the accounts receivable.

16 Segment disclosures

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the Company's chief decision maker in deciding how to allocate resources and assess performance. The Company's chief decision maker is the Chief Operating Officer.

The Company's reportable segments are its commercial operations related to the sale of diagnostic breath kits and contract research and analysis (Diagnostic division), its research and development operations, which are focused primarily on the development of ISA247 (Therapeutic drug division), and its corporate operations, which include all interest income and any common costs for the Company. The accounting policies used in these business segments are the same as those described in note 3 – significant accounting policies.

The Company assesses the performance of each segment based on net income (loss), which represents revenue less operating expenses, plus/less other income (expenses) and capital taxes. Intersegment sales are recorded at the exchange value, which is the amount agreed to by the parties. There were no significant intersegment sales during the year ended December 31, 2003 and 2002.

Reporting segments

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Operating revenue		
Diagnostic	1,580	1,484
Therapeutic drug	8,355	17,277
	9,935	18,761
Amortization of property and equipment		
Diagnostic	43	60
Therapeutic drug	1,160	393
Corporate	555	341
	1,758	794
Net income (loss)		
Diagnostic	204	114
Therapeutic drug	(4,611)	6,213
Corporate	(14,586)	(6,903)
	(18,993)	(576)
Total assets		
Diagnostic	2,480	1,916
Therapeutic drug	9,714	10,576
Corporate (includes unallocated cash and equivalents)	84,330	67,292
	96,524	79,784
Capital expenditures		
Diagnostic	40	-
Therapeutic drug	3,096	6,105
Corporate	841	2,483
	3,977	8,588

The following geographic area data includes revenue based on customer location and long-lived assets based on physical location. The Company has locations in Canada, USA and Barbados.

Geographic information

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Revenue		
USA	8,355	14,097
Canada	827	758
Southeast Asia	606	523
Other	137	179
Europe	10	3,204
	9,935	18,761
Property and equipment		
Canada	9,706	8,352
USA	1,450	641
	11,156	8,993

17 Supplemental disclosure of cash flow information

Net change in other operating assets and liabilities:

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Accounts receivable	3,138	(2,896)
Inventories	85	57
Prepaid expenses and other	(64)	467
Accounts payable and accrued liabilities	2,116	566
	5,275	(1,806)

Supplemental disclosures:

	2003 $	2002 $
	(in thousands of Canadian dollars)	
Interest paid	46	33
Interest received	1,902	1,583
Capital taxes paid	146	159
Equipment acquired under capital lease	510	441
Leasehold improvements related to lease inducements	536	-

18 Related party transactions

a) Included in prepaid expenses and other is a loan receivable from an officer and director in the amount of $189,000 (2002 – $189,000). The loan, effective January 1, 2003, bears interest at 5% per annum and is unsecured. The term of the loan has been extended to December 31, 2004 from December 31, 2003.

b) Included in corporate, administration and marketing expense are consulting fees to a director in the amount of $198,450 (2002 – $117,750). These services are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

19 Comparative figures

Certain 2002 comparative figures have been changed to conform with the current year presentation. These changes do not affect the net loss for the year or deficit at end of the year.

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